Contingent liability management

International Best Practice and
Regional Application
Central Europe & Baltic Countries

PPP Workshop
Riga
Latvia
May 11, 2009

Agenda

- **Project finance and project risks**
- Contingent liabilities management

Project Finance – the key to PPPs

- Project finance is the method used to raise long-term financing for large infrastructure projects
- It includes loans, equity and bonds raised from private finance providers (banks, investors, promoters)
- It is based on highly leveraged, non-recourse lending against the cash-flows generated by the project
  - no recourse on the resources of the project sponsors

Investors and lenders require adequate risk-return ratios

- Investors have traditionally invested in emerging economies to diversify their risk and increase their return
  - By spreading their activities to new markets, they attempt to reduce the overall volatility of their portfolios
  - By investing in less mature markets with high growth potential, they hope to obtain comparatively higher return on their investments (compensating for the higher risk)
- Despite their willingness to accept greater risks, there are certain risks investors ar reluctant to bear, especially
  - Those they do not control well
  - Those which could have a large negative impact on project profitability

Private investors generally bear construction, operational, commercial and financial risks

- **Risks should be allocated to those best positioned to control, anticipate, or hedge against them**

- **In general, in PPPs:**
  - Force majeure, political and regulatory risks: assumed by the government or third parties
  - Construction and operational risks: assumed by the private sector
  - Demand and financial risks: mostly assumed by the private sector

- **Thus, various mechanisms are often used to shift risks between project company and government or third parties**:
  - Project contract
  - Insurance
  - Third party Partial Risk Guarantees (with or without sovereign counter-guarantee)
  - Other specific government guarantees
  - Liquidity facility

Guarantees are used to shift specific project risks to third parties

- Domestic government guarantees
  - shift project risks to the government
  - can cover extensive range of risks
  - project credit rating capped by sovereign rating

- Guarantees from third parties (e.g. multilateral institutions)
  - enable the projects' rating to exceed the country's limit
  - usually cover politicial and regulatory risks, and force majeure
  - some also cover commercial risks (such as demand and foreign exchange risks)

These are often unavoidable…

- Project risk allocation, including use of guarantees, must aim to ensure that a viable project can be put out to bid that will:
  - Attract investors
  - Be socially sustainable
- Some endogenous elements influence investors' and lenders' inclinaison to invest in a given project:
  - Extent to which tariffs cover costs
  - Political and regulatory risks
  - Track record with PPPs
  - Business environment
- In general, the pressure to provide gaurantees increases with the volatility of elements under the control of the government

… but must be minimized …

- **In theory, government guarantees must only be used:**
  - For risks under the control of the government
  - When they are necessary to protect private investors from these risks
  - With terms and conditions strictly limited to those necessary to achieve an adequate protection

- **Whenever possible, guarantees can be combined with reverse agreements**
  - in Chile, minimum revenue guarantees have been combined with revenue-sharing agreement
  - Also true for exchange rate guarantees in Chile and Korea

…and the fiscal obligations they create taken into account

- **PPPs often used to generate fiscal savings while promoting investment** (i.e. to create fiscal space)

- **PPPs generally improve the government's overall net worth**
  - The present value of the obligations they create should be less than the reduction in government expenditures or increase in revenues they generate

- **Key fiscal benefits from PPPs result from:**
  - Under Maastricht criteria, PPPs enable more investments within existing "fiscal space"
  - PPPs can reduce the long term cost of providing a service
  - PPPs often facilitate increases in users' fees

- **But, the fiscal liabilities they create need to be taken into account to:**
  - Enable fully-informed comparisons between public financing and PPPs
  - Understand the true long-term fiscal effect of the project

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- Project finance and project risks
- **Contingent liabilities management**

Fiscal liabilities are generally classified in four categories

- **Direct liabilities**: predictable obligations
- **Indirect / contingent liabilities:** obligations triggered by a discrete but uncertain event
- **Explicit liabilities:** defined by law or contract
- **Implicit liabilities**: de facto obligations for the government

Hanna Brixi Polackova (1998)

PPPs generally do not immediately increase government debt but create liabilities

- **Explicit contingent liabilities***:* promises or guarantees of payments by the government to the concessionaire explicitly mentioned in the contract and triggered by exogenous events (e.g. minimum revenue guarantee)
  - **Explicit direct liabilities with uncertain amounts:** payment commitments by the government to the concessionaire which will have to be made with certainty, but whose size is not known at the time of signing the concession contract (e.g. land expropriation compensation)
  - **Explicit contingent assets (payments):** promises of payment by the concessionaire to the government explicitly mentioned in the concession contract and triggered by exogenous or endogenous events (e.g. revenue sharing agreements)
- **Implicit contingent liabilities:** risks inherent to a concession program, which are not specifically stipulated in the concession contracts, but have been shown to sometimes turn into liabilities of the government by international experience (e.g. early termination risk)

Europe's experience is no exception to this

	Direct (obligations in any event)	**Contingent** (obligations if a particular event occurs)
Explicit (created by law or contract)	▪ Obligation to purchase the output of the private partner (e.g. UK)	▪ Revenue guarantees (e.g. Spain, Hungary) ▪ Debt guarantees (e.g Poland) ▪ Liabilities guarantees (e.g. Czech Rep., Hungary, Poland, Estonia, Latvia, Lithuania, Solvakia) ▪ Exchange rate guarantee (e.g. Spain)
Implicit (political obligation of the government)		▪ Assumption of debt / obligations of concession companies or utilities (e.g. UK, Hungary, Poland)

Contingent liabilities are often problematic

- Contingent liabilities:
  - Often escape proper fiscal scrutiny as a result of their non-cash, long-term nature
  - This may create possible biases in decision making, crowd-out other expenditures, and make governments bear unnecessary risks
  - Decrease the credibility and predictability of fiscal policy
  - May contribute to threats to the long term fiscal sustainability (i.e. financial solvency of the state)

- Thus, contingent liabilities may blind governments to future fiscal costs and risks

There is a broad consensus on the characteristics of a sound fiscal management system

- Desirable fiscal outcomes are generally regarded to be:
  - macro-economic stability
  - policy control over the size of government
  - efficient and effective allocation of public resources to strategic and operational priorities within the budget process
  - efficiency and effectiveness in the delivery of public services

- Characteristics of a sound system for managing fiscal policy and public expenditure (see IMF transparency framework):
  - widely available comprehensive, reliable information
  - open processes of budgeting
  - accountability of policymakers for long-term fiscal risks (incl. for the adequacy of risk analysis supporting government decisions)
  - independent assurance of the accuracy of fiscal information

Implementation of these principles require adoption of improved fiscal tools

- The implementation of these principles in a manner that is widely seen as good practice is through:
  - adopting a multi-year timeframe for fiscal planning and forecasting
  - extending the coverage of the accounting system and ultimately the budget system to cover all financial activities of the government
  - introducing modified or full accrual accounting to capture significant assets and liabilities
  - identifying and reporting contingent liabilities

Good management of contingent liabilities has two components

- **First: making sound decisions on concessions *ex ante***
  - requires a complete and accurate estimation of the financial costs and revenues associated with a concession when decisions are made
  - requires a reasonable estimate of the variability of these financial flows
  - requires that decisions about these expenditures be a normal part of the budget process, the expenditures competing for access to government resources alongside other claims

- **Second: designing and implementing policies to manage the volatility of cash flows efficiently *ex post***
  - All flows of public expenditure are volatile to some degree, thus PPP guarantee cash flows are usually singled out when they are highly volatile or are a large proportion of government expenditure

- **Both components should be supported by budget documents**
  - the accounts of the government should capture the financial flows accurately throughout the life of the project

Making sound decisions ex ante can be helped by quantifying large contingent risks

- **Objectives:**
  - Enable fully-informed comparisons between public financing and PPPs
  - Understand the true long-term fiscal effect of the project
  - Control future contingent liabilities

- **Minimum requirements:**
  - Information on expected value of payments to be made under the guarantees each year
  - Information on the present value of the stream of payments
  - Information on existing contingent liabilities and fiscal objectives

- **Required tools:**
  - Technical tools for assessing expected values
  - Data base of contingent liabilities

Contingent risks can be quantified using option-pricing theory

- The value of a guarantee can be estimated as an imaginary commercial fee for a guarantee of this type
- Most guarantees can be thought of as a combination of put and call options and can thus be valued using option-pricing formulas
- Monte-Carlo simulation and other numerical techniques can be used to accommodate the features of more complex guarantees and estimate the volatility of cash outlays
- Countries with experience in the valuation of government guarantees include Canada, Colombia, Chile, the Netherlands, Sweden, Turkey and the USA

This information should be used in decision-making, fiscal planning,…

- **Decision making:**
  - Build long-term fiscal scenarios (e.g. UK, New Zealand, USA)
  - Compare options (PPP vs public provision; guarantees vs cash subsidies, etc)

- **Fiscal planning**:
  - Long-term fiscal projections allow governments to reflect possible future spending in fiscal targets
  - May be complemented by ceilings on government risk exposures
    - ceiling on face value of outstanding guarantees or on new guarantees p.a. (e.g. Hungary, Poland, Latvia)
    - ceilings on total budget and off-budget support per sector
  - Requires a data base of government direct and contingent obligations

… reporting …

- Reporting contingent liabilities requires making choices on:
  - The instrument in which to report
  - The definition of a contingent liability
  - The type of contingent liabilities to report
  - The conditions when reporting is required
  - The scope of information to report on each of them
  - The valuation methodology to use if a value is to be reported
  - The type of audits required of the reported information

… and budgeting and accounting

- Budgeting for contingent liabilities implies making choices on:
  - The institutions responsible for the budgeting
  - The accounting principles to follow
  - The amount to be budgeted or accounted for each year

- A key objective is to create a trade off between money spent on guarantees and money spent on other things (“cash neutrality”)

Various policies can be contemplated to manage the volatility of cash flows efficiently

- **To prepare for potential large guarantee outlays, appropriations can be made through the budget to make provision for probable claims**
  - In cash accounting system: appropriation of cash
    - the cash can be retained by MoF but needs to be managed in recognition of the legal liability to fund any guarantees that would be called up
    - the cash can be placed in an account at the Central Bank and earmarked for backing contingent liabilities
  - In accrual system: reduction in net worth via journal entry creating a reserve

- **A contingent liability fund can be created to accumulate financial assets from budgetary transfers and/or fees collected from guarantee beneficiaries (e.g. Netherlands, Canada, Colombia)**
  - Sector ministry transfers amount equal to NPV of guarantee when guarantee created or transfers annual amounts equal to expected payments
  - Payment of guarantee fee by beneficiary based on future fiscal costs (e.g. Sweden)
  - Fund can be managed by private party to avoid money use for other purposes

- **Alternative: standby credit agreement with a bank to borrow in case of payments**

The question of the amount to be appropriated is likely to be contentious

- No widely accepted and precise method
- Likely to be annual arguments about it
- Should not be maximum exposure that might be incurred under the guarantee, as this would greatly exceed probable payments
- Realistic options include appropriating:
  - an estimate of the expected payments under the guarantees, discounting at the risk free rate of interest
    - such an estimate would take into account the expected value of payments to be made by the government but ignore the cost to the government of being exposed to cash flow volatility
  - an estimate of expected payments plus a margin (fixed by a rule of thumb) intended to account for the cost of risk
  - an estimate of the present value of the payments based on option-pricing techniques

These efforts need to be coupled with a clear fiscal risk management strategy

- Fiscal risk targets
- Separation of risk taking and risk appraisal / monitoring functions
- Clear responsibility within government for contingent liability management:
  - Best practice: as part of comprehensive government asset-liability management in debt management office (e.g. Sweden, Belgium, Ireland)
  - Alternatives: in budget office of MoF, in dedicated PPP office
- Promotion of awareness of long-term fiscal costs and risks (local and central governments)

Contacts

For comments or further details contact:

Cledan Mandri Perrott	cmandriperrott@worldbank.org
Sabino Escobedo	sescobedo@tagfinancialadvisors.com
David Stiggers	davidstiggers@comcast.net
Sophie Sirtaine	ssirtaine@worldbank.org

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THANK YOU!

Radek Czapski

World Bank
Warsaw Offcie
Tel: + 48 22 520 80 00
Fax: + 48 22 520 80 01
E-mail: rczapski@worldbank.org